UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 3273 / September 7, 2011

ADMINISTRATIVE PROCEEDING
File No. 3-14536

In the Matter of

MONTFORD AND COMPANY, INC. d/b/a MONTFORD ASSOCIATES,

and

ERNEST V. MONTFORD, SR.,

Respondents.

RESPONDENTS' PREHEARING BRIEF

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RESPONDENTS' PREHEARING BRIEF

Pursuant to this Court's October 5, 2011 Order, Respondents submit this Prehearing Brief.[1] In Part I, Montford will outline the facts: background on Montford Associates; Montford's use of hedge funds of funds; Montford's experience with Stanley J. Kowalewski and his firm ("SJK"); SJK's performance generally prior to the fraud; Montford's due diligence; and Montford's work for SJK. In Part II, Montford will address Division's allegations concerning the alleged infraction: Montford's receipt of $210,000 from SJK for the work that Montford did for SJK in connection with the transfer of SJK's business from Columbia Partners to SJK's own firm. In Part III,

[1] On October 24, 2011, this Court denied Respondents' unopposed motion for a one-day extension of time to file this brief; the purpose of the extension would have been to allow Respondents the opportunity to tailor its submission to the prehearing brief filed by Division. Apart from the summary outline of charges set forth in the Complaint, Respondents have not received from Division any narrative or brief, or any discussion of cases or other legal authorities. This brief, therefore, of necessity anticipates arguments that Division may actually advance in this case.

Montford will address the facts and law relating to the remedies that Division may seek in this case.

As an introductory statement, Montford has recognized throughout these proceedings that it should never have accepted any payment from SJK and that doing so was inconsistent with the representation in Montford's ADV and its marketing material that it would not accept fees from a manager. Montford also understands why the disclosures in the ADV are necessary and how critically important it is for Montford's clients to know when and if Montford would have any possible conflict of interest. *See S.E.C. v. Capital Gains Research Bureau,* 375 U.S. 180, 201 (1963). Yet, as will be explained in greater detail below, the payment from SJK was for legitimate services Montford provided to SJK. At the time, Montford did not believe it posed a conflict of interest since the payment was in no way connected to investment advising services. Regardless of the outcome of this proceeding, Montford regrets the mistake. Montford has paid dearly for this mistake and there can be no doubt that it will never happen again.

PART I. FACTS

As the Court is well aware, this case arises from the massive fraud of SJK, which as described below and in the Division's Order Instituting Public Administrative Proceedings ("OIP"), occurred when SJK caused investors to pay SJK improper fees, which SJK, in part, used to pay his personal expenses and business operating expenses.

A. Montford Associates

Montford Associates was founded in 1989 by Ernest V. Montford, a seasoned investment advisor with long tenures at Merrill Lynch & Co., Inc. and E. F. Hutton & Co. Montford Associates and Ernest Montford are registered investment advisors licensed

by the S.E.C. In its 22 years, Montford has attracted a variety of institutional investors, but most of Montford's clients now are non-profit foundations, educational institutions, and quasi-governmental entities, such as the Community Foundation of Gwinnett County, the Georgia Ports Authority, Piedmont College, and, most recently, The Scott Hudgens Family Foundation. These first class institutions with substantial assets could have selected any investment advisor in the country, and Montford takes great pride in having been retained by them, year after year, to provide investment advice.

Montford has an unblemished record of compliance with the law. Montford has never been cited for any violation of the law no matter how minor or trivial. In fact, prior to the SJK fraud, none of the brokers or managers that Montford had worked with had ever been cited for any violation of the law.

The fees that Montford charges its clients are reasonable and based solely on the amount of funds that Montford has under management. Montford's fee schedule is disclosed in a standard engagement letter. Montford does not recall having any disputes with clients over fees.

Montford is a small company, but is staffed by professionals with big firm qualifications. Mr. Montford earned a B.B.A. in management from the University of Georgia and completed the requirements of the Certified Investment Management Analyst program of IMCA at the Wharton School of the University of Pennsylvania. As noted above, prior to forming Montford Associates, Mr. Montford worked for many years at Merrill Lynch and E.F. Hutton.

Montford analyst Jeanne G. Heeley graduated from Georgia State with a B.B.A. in finance. Ms. Heeley is primarily responsible for managing data collection and performance management systems, including the review and reconciliation of

statements from custodians and the generation of quarterly reports for Montford's clients. Montford's Director of Research throughout this period, Mr. R. Brandon Burnette, earned a B.S. in management with a certificate in finance from Georgia Institute of Technology and a M.B.A, with a certificate in finance, from Boston University. Prior to joining Montford in 2008, Mr. Burnette worked for Homrich & Berg, Inc., a wealth management firm, and Rock-Tenn Company.

B. Hedge Fund Of Funds And Investment Strategy

Montford develops investment strategies to meet the particular needs of individual clients. Many of Montford's clients place a higher value on the preservation of capital than on maximizing the potential for fast growth. For these clients, Montford will generally recommend investments that have a relatively low volatility and, in some instances, investments that are hedged against various economic conditions.

One particularly appropriate kind of investment for institutions valuing security and preservation of capital over growth is a hedge fund of funds. Though known by different names, hedge fund of funds have been an investment vehicle of choice for decades at the largest and most prestigious endowments in the world, including Harvard and Yale. The basic concept of a hedge fund of fund is simple: an investment that is divided among funds having contrasting investment strategies is likely to be less volatile and can be "hedged" against various economic conditions. The key to a successful fund of funds is the fund's manager's ability to select the right mix of underlying fund managers and to allocate the right percentage of money between them.

Montford has recommended that clients invest in hedge fund of funds for many years. Montford's clients have been invested in at least six different fund of funds,

including Common Sense, Oakbrook Market Neutral, PIMCO All Asset, as well as Summit and SJK, discussed in greater detail below.

Finding a hedge fund of funds manager is just the start. Not all hedge fund of funds are the same, and even some that are generally well managed do not perform well over time. For example, the fund of funds manager who founded Summit Partners (Ron Karp) achieved an astonishingly high average annual return of 13% from 1991 through 2007. Mr. Montford knew this manager well and knew his track record. In the mid-2000's, Montford made the recommendation to some of its clients to invest in Summit Partners, and they did so. In 2008, a horrible year for investing, Summit's fund of funds lost over 30% because, Montford believed, too much of its investments in underlying funds were illiquid.[2] Once Summit's poor performance was detected, Montford immediately advised its clients to divest their investments in Summit, and many did so.

C. SJK's Fund Of Funds

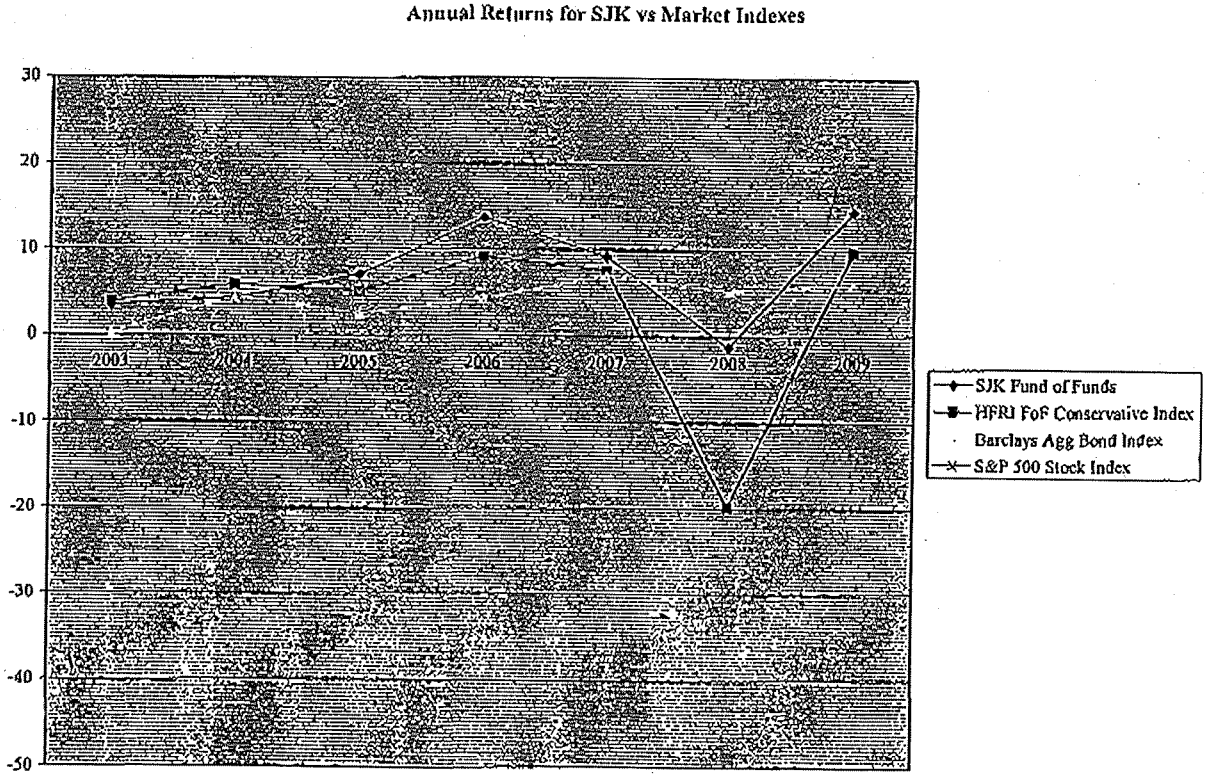
Another fund of funds manager that Montford starting using in the 2000s was SJK, who at the time had his own firm called Phoenix Partners. SJK was referred to Montford in 2002 by a contact in consulting, Mr. Hal Chappell. Over the next year, Montford met and corresponded with SJK to determine if SJK would be a good fit for any of his clients. One of Montford's smaller foundations had certain institutional constraints requiring particularly low-risk investments, and SJK had the appropriate fund of funds. This foundation invested with SJK in 2003 and remained an SJK client until the S.E.C. disclosed SJK's fraud in early 2011.

[2] By contrast, for the same year SJK's fund of funds broke even, and SJK's fund of funds for Georgia Ports Authority *gained* over 5%. The average fund of funds lost over 19% in 2008.

Since 2003, Montford has recommended SJK to many clients. As of December, 2010, sixty percent of Montford's clients had money invested with SJK, representing 15% of Montford's assets under management

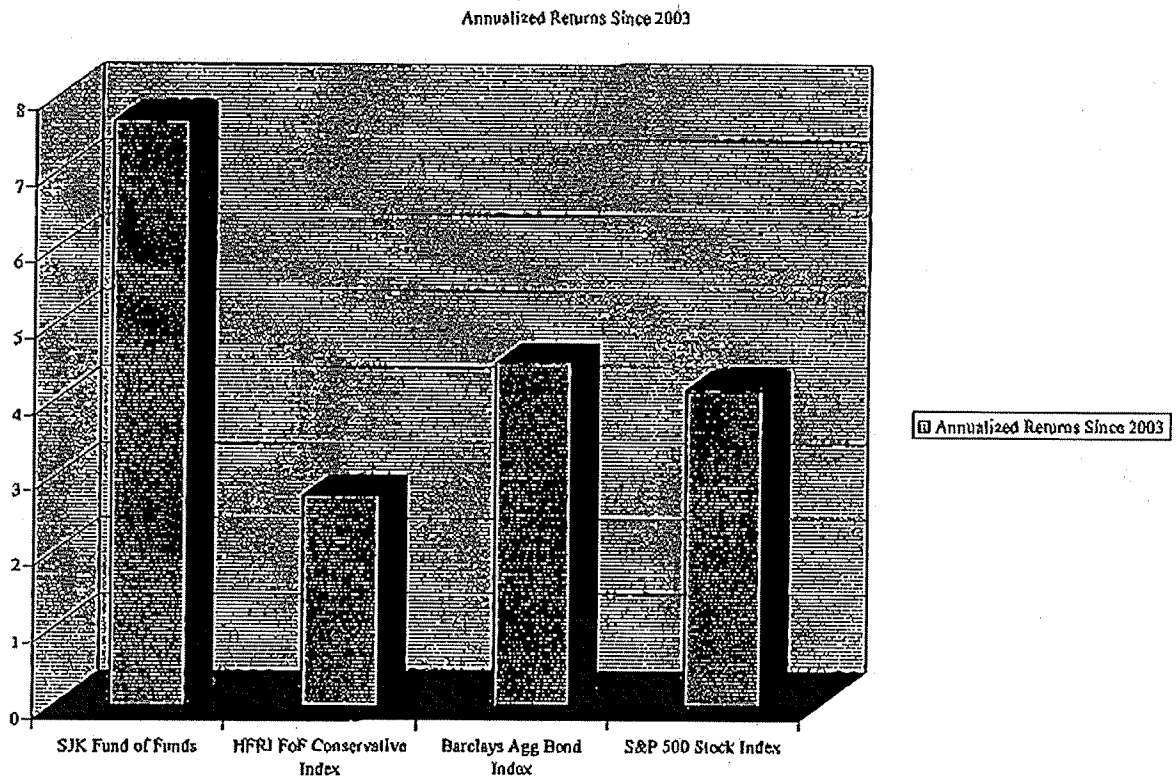
In February 2010, Ernie Montford – convinced that SJK was a solid and safe investment – invested his personal retirement account (worth over $200,000) with SJK.

Over the years, SJK's performance has been outstanding by any measure. Chart 1 compares SJK's performance to the performance of the HFRI Index of Conservative Fund of Funds, Barclays Agg Bond Index, and the S&P 500 Stock Index for the period 2003 through 2009:



As this chart shows, SJK's returns were both less volatile and measurably higher than the HFRI Index. And, although the S&P outperformed SJK in 2009, S&P's

cumulative returns over the seven year period were not nearly as good. Indeed, of the four, SJK's annualized returns since 2003 were the highest, by far:



SJK's returns may have been the most impressive in 2008, the year in which the S&P 500 dropped 37%, more than it had in any year since 1937. Even other hedge fund of funds – specifically designed to weather economic cycles – lost, on average, 20%. SJK's funds were down only 1.5%, net after fees.

D. SJK's Movement In And Out Of Columbia Partners

Over the years, SJK's funds migrated from organization to organization. When Montford first started recommending SJK, SJK owned a firm called Phoenix Partners. In 2004, SJK sold Phoenix Partners to Global Alternatives in Atlanta, but SJK continued to manage the funds. In 2005, Columbia Partners – a large stock and bond manager with $3 billion in assets – hired SJK to create a similar hedge fund of fund business as a

separate division of Columbia. At that time, Montford assisted with the transfer of Montford's client's funds from Global Alternatives to Columbia at no charge to either Montford's clients or to SJK.

In 2009, SJK informed Montford that SJK might be leaving Columbia to set up his own firm because of differences with the firm's owners over SJK's compensation. Montford advised SJK to not make the move in light of (a) the number of moves that SJK had already made in the prior years, (b) the increased sensitivity of the investing public caused by the Madoff scandal, and (c) the administrative difficulties associated with transferring the funds and setting up his own business. SJK nevertheless decided to leave Columbia and set up his own company.

When SJK left Columbia, Montford's clients that had funds invested in Columbia had three choices. First, they could leave the funds invested with Columbia. Second, they could withdraw the funds and invest with another manager altogether. Third, they could move the funds with SJK and reinvest in what would be an almost identical hedge fund of funds, with the same underlying funds and only a nominally different top-level fund manager (SJK NewCo instead of Columbia Partners, managed by SJK).

At the time, Montford was considering these options with his clients, Columbia announced that it was exiting the fund of funds business and that it would not support Montford's clients' investments. That left only two options – stay with SJK or find a new fund of funds manager. Though moving to a new fund of funds manager was clearly an option available to Montford's clients, there was no compelling reason to make such a move and strong reasons to stay with SJK. As noted above, SJK had shown the ability year after year – and most immediately in 2008 – to sustain good returns and, most important, to avoid losses of capital in hard times. Since SJK's record far

surpassed other fund of funds managers, most of Montford's clients elected to stay with SJK.

In July 2009, at SJK's request, Montford began assisting SJK with the transfer of Montford's clients' funds from Columbia to SJK's new company. Initially, when SJK's funds were housed within Columbia, Columbia had sufficient administrative expertise to handle the administratively complicated work associated with managing a fund of funds. When SJK left Columbia, Columbia made the decision to liquidate the funds and exit the "hedge fund of fund" business entirely – but did so without retaining the administrative expertise necessary to appropriately handle Montford's clients' accounts. For its part, SJK's new operations also did not have this kind of administrative experience or expertise. The work necessary to take care of Montford's clients' accounts therefore "defaulted" to Montford – but it was work that Montford, in all fairness, had no responsibility for completing. Montford was paid to advise clients, not to administer or transfer funds from one hedge fund of funds to another.

Montford knew from experience that this effort would be time consuming. But the move from Columbia to SJK's new company proved even more difficult. For reasons that were never made clear to Montford, Columbia refused to transfer the funds "in kind" simply by changing the identity of the owner of the top-tier funds (and not disturbing the ownership of the monies in the underlying funds). As a result, Montford's clients' interests in the underlying funds had to be redeemed, the proceeds distributed to the respective Columbia fund of funds, then transferred to the new SJK fund of funds, and then invested again in the underlying funds. Each of these steps had to be completed for each of Montford's eight clients, each of which had interests in eleven underlying funds.

The work that Montford's staff did to transition the funds from Columbia to SJK's new funds was substantial, and involved several "waves" of activity:

- In early July 2009 (approximately July 10), SJK informed Montford that SJK was leaving Columbia and would need help transitioning the underlying funds for Montford's clients. Montford's staff spoke to each of its eight clients to explain what Columbia was doing.
- Montford then received and processed the forms necessary for investing in the SJK funds.
- On July 14, 2009, Columbia sent an announcement directly to Montford's clients informing the clients that the Columbia fund of funds was going to be liquidated. This was unexpected. The announcement was poorly handled, and required Montford to meet with each of the clients to explain the mechanics of the transfer.
- Montford then worked with clients assisting them make their requests to Columbia for "in kind" transfers. Columbia, however, refused. Mr. Montford met with Columbia's COO to try to change Columbia's mind, to no avail. As a result of this refusal, Montford's staff had to complete another round of paperwork.
- Complicating matters, Columbia circulated conflicting notices to investors as to when investors had to notify the fund of their intent to withdraw. Columbia first sent an announcement stating that all investors had a July 31 notification deadline to withdraw from the fund by August 31, 2009. This short notice prompted a flurry of activity involving bank wiring instructions, withdrawal notices, and the like.
- By August, however, Columbia circulated a new notice that the closure date was being changed from August 31, 2009 to September 20, 2009, a change that required Montford to go through the whole process again. There was additional confusion

when it appeared that the real closure date was not September 20, but September 30. Worse, Columbia – which had no staff with experience liquidating a fund of funds – circulated incorrect forms and instructions.

- These administrative mistakes were very unsettling to Montford's clients, and Montford was required to meet with many face-to-face, to assure them that, with Montford's staff's guidance, Columbia would transfer the funds correctly.
- Finally, by October 15, 2009, 90% of the funds that had been invested in the Columbia Funds had been transferred. From October 2009, through the beginning of 2010 (and to some extent long thereafter), Montford worked with Columbia and SJK to secure the transfer of the remaining funds.

Though Montford had started to assist SJK without a commitment by SJK to pay for the services, by August 2009 the amount of work required of Montford had become unreasonably burdensome. During the week of August 25, 2009, Ernie Montford told his staff that he believed the company should not do this work for free, and his overburdened staff heartily agreed. Since it was not an expense his clients should have endured, Montford called SJK and told him that Montford needed to get paid for the work. SJK agreed that Montford would be paid a fee for the work. SJK did not tell Montford how SJK would calculate or determine the payment. From Montford's perspective, any payment would be more than Montford was expecting prior to that conversation; Montford had a good relationship with Kowalewski at the time, and Montford had every reason to believe that the fee would be modest but also reflect the effort his company was undertaking on behalf of SJK.

The amount of money that SJK would pay Montford had nothing whatsoever to do with the amount of funds Montford's clients would or might invest in SJK. Toward

the end of 2009, SJK's accountants told Montford that payment would be made in 2010. SJK ended up paying Montford $130,000 in January 2010 and $80,000 in November 2010.

Significantly, SJK's agreement to pay Montford for its work came long after Montford's clients had decided to transfer their funds from Columbia to SJK. On July 23, 2009, Montford wrote Columbia Partners and informed Columbia that all of Montford's clients "would like to avoid any unnecessary taxable event and all desire to exit the Columbia Absolute Return fund and transfer their interests in the Underlying Fund Managers to either the SJK Absolute Return Fund LLC or the offshore version, SJK Absolute Return Ltd." Montford did not discuss payment with SJK until the end of August 2009.

Though the work associated with assisting SJK set up his new company was an administrative headache, it did have one important benefit. Through its efforts, Montford was able to confirm that SJK, while at Columbia, had been a good steward of Montford's clients' funds – every penny that SJK said had been invested in his fund of funds was accounted for and was transferred, safely, to SJK's new company. In addition, though SJK's funds of funds were "housed" within a different company, the same management team that had produced such excellent results remained in place.

E. Due Diligence

Montford conducted substantial due diligence on SJK, far more than is customary or required in this field. The due diligence was not just conducted when Montford first recommended SJK, but continuously. For example, in 2008, Montford sent an analyst to SJK in Greensboro, South Carolina, where he scrutinized SJK's operations within Columbia Partners. In July 2009, after Montford had been given

word that SJK was leaving Columbia, Montford called Bob Van Pentz, the CEO of Columbia, to verify the circumstances of SJK's departure. Van Pentz stated that SJK's departure had been driven by a dispute between Columbia and SJK over the value of SJK's book of business – just as SJK had said. Later, in the transitioning of the funds from Columbia to SJK's new company, Montford was able to confirm that every penny of his clients' money invested with SJK had properly been accounted. Several months later, Montford sent an analyst to Greensboro again to review all aspects of SJK's operation. Again, everything appeared in order.

In 2010, SJK met with Montford in Montford's office to review strategy, markets, and how SJK's new operations were functioning. Also in early 2010, Montford requested and received a list of SJK's clients, which SJK promptly provided. The list did not raise any questions. Further, Montford confirmed that SJK had engaged some of the most respected financial institutions in the business to serve as custodians, including Goldman Sachs and Banque Paribas.

In sum, Montford had no reason not to recommend SJK to clients that needed a low risk investment to preserve capital. Given SJK's performance over the years, it was most reasonable for Montford to recommend that these clients invest with SJK.

In assessing the facts regarding Montford's due diligence, it is important to note that, during the critical period from the fourth quarter 2009 through December 2010, Montford did not have the benefit of the facts that were being uncovered by the S.E.C. in its ongoing investigation, discussed below.

PART II. DIVISION ALLEGATIONS

In retrospect, it is clear to Montford that it should never have accepted payment from SJK and that doing so was inconsistent with Montford's representation in its ADV

that it would not accept fees from a manager. Montford understands fully why the ADV's disclosures are required and how critically important it is for Montford's independence to remain beyond question. This will never happen again.

For the proper legal resolution of this case, however, Montford must address directly several of Division's key allegations.

A. Montford Was Not Paid By SJK To Refer Clients

Montford was not being paid to send clients to SJK but instead to help set up SJK's new company. The work Montford did for SJK was substantial and critically necessary to ensure that Montford's clients' funds were transferred securely from Columbia to the new SJK companies. Even SJK acknowledged that his start-up company had to have Montford's assistance, and that transitioning the funds from Columbia to the new company was an absolute "nightmare." (SJK April 2010 Dep. p. 25). The work that Montford's team did for SJK was necessary for the safe transitioning of the funds and the safe transitioning of the funds was clearly in the best interests of Montford's clients. This stands in sharp contrast to those cases in which the investment advisor has a direct financial incentive to direct clients to a broker who is, in essence, sharing the fee with the investment advisor. *See Matter of Sheer Asset Management, Inc.*, 1995 CCH Dec. ¶ 85,609 (S.E.C. 1995) (civil penalty of $25,000 for undisclosed deal where broker retired $150,000 debt with percentage of brokerage commissions from investment advisor's clients).

Division alleges in Paragraph 11 of the OIP that Montford told SJK that Montford needed to get paid for his work, "including recommending SJK." There is no evidence to support this charge. Both Montford and SJK testified otherwise. Furthermore, Montford's clients were *existing* investors in SJK; the work that Montford did was

limited to the mechanical work associated with transferring their assets out of one fund of funds and into another.

The key evidence in this respect (apart from Montford's testimony itself) is the July 23, 2009 letter from Montford to Columbia in which Montford notifies Columbia that *all* of Montford's clients had already decided to go with SJK. Montford did not ask SJK for payment for the services until late August. Thus, by the time Montford asked SJK to pay Montford for its services, Montford had already advised its clients and its clients had already decided to make the move. From Montford's perspective, Montford had no conflict of interest because Montford, at all times, was going to be paid the same whether Montford recommended SJK or another fund of funds manager.

Division also suggests in Paragraph 14 of the OIP that the description of Montford's services on its invoice to SJK was suspicious – "Marketing and Syndication Fee for the SJK Investment Management LLC Launch." This allegation is materially misleading, as Division is well aware. As Montford testified, the invoice that Montford's originally invoiced gave the following description of the services rendered: "Consulting Services for the SJK Investment Management LLC Launch." SEC-SJK-003289. After issuing this invoice, Montford received a call from SJK's accountant (Montford is not sure if it was Mr. Fulcher or an outside accountant) who requested that the description of the services be changed to "Marketing and Syndication Fee." As Division is also well-aware, SJK himself testified that Montford performed "consulting services." In addition, SJK's General Ledger classifies the payments to Montford as "Professional Fees," a classification that is completely consistent with Montford's (and even SJK's) testimony. SEC-SJK-004003.

Division also makes the same allegation in Paragraph 12 and 14 to the effect that Montford recommended SJK to clients before and after SJK paid Montford. This is of course true. It is also true that Montford would have been paid just as much by SJK had Montford advised clients to invest elsewhere. In fact, Montford did advise *some* clients to invest elsewhere (only 15% of its assets under management were with SJK), and even tried unsuccessfully to dissuade one of its clients from investing more money in SJK as late as mid-2010. The fact remained that although SJK was not a suitable investment for every client, and every client needed carefully balanced portfolios, for those clients needing a low-volatility fund to hedge against market extremes, SJK was an excellent choice by any objective measure. Yes, Montford "recommended that clients invest additional funds with SJK," as Division alleges in Paragraph 14, because, based upon what everyone[3] knew at the time, SJK was a very sound investment. The recommendations were in no way connected with SJK's payment to Montford.

B. Savannah Country Day School

Division alleges in Paragraph 14 that Montford dissuaded one client, which was Savannah Country Day School ("SCDS"), from withdrawing its investment from SJK. The facts demonstrate that Montford did not breach any duty with respect to SCDS. The Endowment Committee of SCDS did decide in early 2010 that SCDS should divest itself from SJK primarily because of the perceived risks and costs of hedge fund of funds in general, rather than SJK in particular. Over the next months, the Chairman of the Endowment committee spoke with SJK directly and with Montford. At the next meeting, the Committee decided to keep the investment. Many months later, some

[3] Except for the S.E.C. and SJK himself, who both knew by early 2010 that SJK was siphoning millions from the funds into a bogus underlying fund managed by SJK himself.

members (who had not attended pertinent meetings in the past) were apparently unaware of the decision to keep the funds invested in SJK.

The minutes from SCDS's Endowment Committee meetings also reflect that some committee members were critical of Montford's work, and other committee members were supportive. This is not remarkable, and does not, by any stretch, indicate a failure on Montford's part to exercise due diligence. In fact, Committee members were also critical of themselves because of the poor attendance at meetings. Further, the Minutes show that not all Committee members were keeping track of the decisions that the Committee as a whole had made. Still, what hurt SCDS was not any committee disagreement, or any lack of due diligence by its advisor, or, perhaps, the failure by the S.E.C. to blow the whistle on SJK. Instead, what hurt SCDS was the unforeseeable fraud of Stanley Kowalewski.

C. Montford Was Totally Unaware Of Any Fraud

Division has not alleged that Montford had any knowledge of SJK's fraud. In an abundance of caution, however, Montford must explain that not only did Montford not have any idea of SJK's fraud, the S.E.C., which was in the process of investigating SJK throughout this entire time period, was completely fooled as well.

The S.E.C.'s investigation of SJK was in full swing by the time SJK opened his new company. By December 2009, the S.E.C. had discovered (unbeknownst to Montford, SCDS, and other investors) that SJK's Form ADV had materially misrepresented SJK's assets under management. SJK had stated in his official filings that he had over $75 million under management. In fact, at the time this representation was made, SJK had just under $21 million under management. Though the S.E.C. knew that SJK had misstated – by $54 million – the amount SJK was managing, that fact did

not alarm the S.E.C. investigators enough for the S.E.C. to warn the investing public or take any serious regulatory action. As a result, the public continued to invest in SJK. Montford himself invested his entire retirement account in SJK in mid-2010, well after the S.E.C. had learned of SJK's material misrepresentations in its ADV.

Worse, by April, 2010, the S.E.C. had learned that SJK had siphoned millions from the Absolute Return Funds into a new, aptly named "Special Opportunity Fund." (SJK Dep. April 16, 2010, p.71, 86) ("We just launched a new fund, the SJK Special Opportunities Fund." "Well, it's just as the name implies, it is a special opportunities fund that looks at a variety of different investments from real estate to fixed income to equities, there's a variety of different things.") SJK further told the S.E.C. that the Special Opportunity Fund had invested in local real estate and had loaned money to a local construction company called Combs. The S.E.C. did not ask who owned the "local real estate" or construction company (the answer: SJK's relatives) or whether such "investments" were consistent with a low-risk hedge fund of funds. The S.E.C. also learned that SJK was not having the Special Opportunity Fund audited, that a local bank had been engaged as the custodian (rather than Goldman Sachs, the custodian for the legitimate funds), and that SJK was administering the fund himself. (*Id.*, pp. 74, 85). The S.E.C. also had reviewed the documentation making it abundantly clear that the Absolute Return Fund was contractually prohibited from investing in a fund managed by SJK, and was contractually prohibited from investing in real estate.

The S.E.C. also knew that investments in real estate and loans to local construction companies were totally out of character for a low risk hedge fund of funds. It was this creation and funding of the Special Opportunity Fund, disclosed to the S.E.C. by April 2010 that led to the massive losses later in 2010, the S.E.C.'s eventual lawsuit,

the receivership, SJK's disbarment and censure. Still, at the time the S.E.C. learned of the Special Opportunity Fund, the S.E.C. apparently did not put the pieces together, did not notify the investing public, and did not take any serious regulatory action. As a result, the public continued to invest in SJK. In December, 2010, a full year after the S.E.C. had learned of SJK's $54 million misrepresentations in the ADV, and 8 months after the S.E.C. learned of the fraudulent Special Opportunity Fund, Hickory Springs Pension Fund invested $7 million in SJK.

The S.E.C. knew far more than Montford about SJK's misdeeds, and still did nothing to stop the fraud or notify investors that something might be amiss. Certainly, the S.E.C. did not issue SJK a "clean bill of health" after its 2009 – 2010 investigation. But the failure of the S.E.C. to uncover fraud supports a strong inference that due diligence would not have uncovered the fraud. *In re Bayou Hedge Fund Litigation*, 534 F. Supp.2d 405 (S.D.N.Y. 2007) (dismissing Section 10(b) claim, holding that "failure to discover the fraud merely places it alongside the S.E.C., the Internal Revenue Service, and every other interested party that reviewed Bayou's finances"). This case is the exact opposite of those cases in which the plaintiff or the S.E.C. argues that the lack of due diligence may be inferred from the fact that other investment advisors were suspicious;[4] here, there is no evidence that anyone, including the S.E.C., had any suspicions of any fraud at the time Montford recommended SJK. SJK, even under a regulatory microscope, was clever enough to fool the S.E.C. Clearly, reasonable diligence would not have discovered SJK's fraud, and there is nothing to suggest that Montford failed to

[4] *Compare In re Beacon Assoc. Litigation*, 745 F.Supp.2d 386 (S.D.N.Y. 2010). Moreover, even if others are suspicious, more evidence is necessary to support a finding of unreasonableness or recklessness. *Id.*

exercise due diligence, or was anything other than honest and independent, in recommending that his clients invest with SJK.[5]

The point of this is not to blame the S.E.C. for not taking the prompt action that would have stopped this massive fraud. Instead, the point is that with the benefit of hindsight, it is not difficult to marshal the undisputed facts in such a way so as to make even the most diligent appear foolhardy and the most honest appear corrupt. This is easy for the greenest lawyer, and child's play for the phalanx of Government lawyers who have awoken to amass themselves to prosecute Montford, himself victimized by the S.E.C.'s slumber. The proper resolution of this case, Respondents submit, requires a distinction between mistakes made by those laboring in good faith, like Montford and the S.E.C., and those bent on violating the law, like SJK.

PART III. RELIEF SOUGHT

Although Division's allegations do not include a prayer for any particular relief, the following considerations should be relevant.

First, Montford's conduct – however assessed – is far less serious than cases in which the Commission has decided to not pursue enforcement actions. The cases that are most on point would not even be reported, of course, as those would be cases in which the process did not even reach the point of a Wells Notice or were resolved shortly thereafter. The reported cases all involve far more serious infractions, but are instructive by way of comparison.

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[5] The scope and nature of Montford's duty must also be kept in perspective. *Cf. Gabriel Capital, L.P. v. Natwest Finance, Inc.*, 137 F. Supp. 2d 251 (S.D.N.Y. 2000) (§10(b) case) ("plaintiff fails to cite a single case that requires an investment advisor to conduct an independent investigation as to the accuracy of the statements made in an offering memorandum when there is nothing obviously suspicious about those statements").

, for example, the defendant investment advisor executed over 1,600 trades while laboring under a conflict of interest that should have been disclosed to his clients. The Commission accepted a settlement imposing a $25,000 civil penalty and no censure.

Similarly, in *Matter of Sheer Asset Management, Inc.*, 1995 CCH Dec. ¶ 85,609 (S.E.C. 1995), SAM, an investment advisor, had entered into a secret agreement with a broker pursuant to which the broker would apply a percentage of the commissions the broker received from SAM's clients to retire a $150,000 debt that SAM owed to the broker – an agreement that placed SAM in a clear conflict of interest with its clients. SAM did not disclose the agreement in its ADV. Over a three year period, the broker received enough in commissions from SAM's clients to retire the entire $150,000 debt. The Commission found SAM's failure to disclose the agreement in its ADV to be "willful." The Commission approved a settlement with SAM providing for: (a) a civil penalty of $10,000 (or less than 10% of the amount of money the broker, in effect, paid SAM for SAM's brokerage business); (b) a requirement that SAM amend its ADV to disclose the brokerage agreement (and any other brokerage agreement with third parties); and (c) a requirement that SAM engage a consultant to review SAM's compliance procedures. The Commission did not censure SAM or suspend its license. In addition, the Commission did not "disgorge" from SAM the amount of commissions that SAM had, in effect, received from the broker. Instead, it imposed a penalty that was less than 10% of that amount.

An instructive decision by the Commission with respect to the appropriate penalty for failures to disclose material information in an investment advisor's Form ADV is *In the Matter of Concord Investment Company*, 1996 CCH Dec. ¶85,855 (S.E.C. 1996). In *Concord*, the Commission found that Concord, a registered investment

advisor, "failed to affirmatively disclose [in its ADV] that its related party, an affiliated broker-dealer under common control, engaged in principal transactions with its [i.e. Concord's] clients." Concord also failed to disclose in the ADV that "an inherent conflict of interest exists when executing a principal transaction through its affiliated broker-dealer under common control." Finally, according to the Commission, Concord had not disclosed "to its advisory clients what restrictions or internal procedures are used in light of the potential conflicts of interest in the principal transactions." *Id.*, page 88,724. Based on the foregoing, the Commission approved the following sanction specified in a proposed settlement: a civil penalty of $20,000 and the adoption of written policies and appropriate training for Concord's employees. The Commission did not order a censure or suspend Concord's license. *Id.* Page 88,725.

These cases place Montford's conduct in context. Here, the evidence supports the conclusion that SJK deliberately defrauded investors for his own personal gain and violated any number of securities laws in the process. SJK clearly deserves severe sanctions. But Montford, under the cases, clearly does not. Especially since the payment from SJK was related to legitimate services provided to SJK that were not, in any way, related to investment advice to clients.

Second, courts and the Commission have emphasized the importance of the advisor's state of mind. *Steadman v. S.E.C.*, 603 F.2d 1126 (5th Cir. 1979); *Monetta Financial Serv., Inc. v. S.E.C.*, 390 F.3d 952, 957 (7th Cir. 2004). As Judge Tjoflat noted in *Steadman*: "It would be a gross abuse of discretion to bar an investment adviser from the industry on the basis of isolated negligent violations." 603 F.2d at 1141. Here, Montford did not know of the SJK fraud, did nothing to advance any of the fraudulent schemes, did not benefit from the fraud, and did not have any incentive to deceive its

clients into investing in SJK. If Montford did not believe in SJK, Montford would never have invested his entire retirement account with SJK. Montford had no intent to harm anyone, and did not believe SJK's payment posed any conflict of interest. *See S.E.C. v. Slocum, Gordon, & Co.*, 334 F.Supp.2d 144, 185, 187 (D.R.I. 2004) (for "non-scienter based, technical violations" refused to impose injunctive relief, instead imposed $3,000 civil penalty).

Third, for a variety of reasons, a disgorgement remedy is not appropriate in this case. Montford was paid by SJK for the services that Montford performed for SJK; there was no unjust enrichment or unlawful gain. In fact, had the payment been unlawful or inappropriate, the S.E.C. would have blown the whistle on SJK in April 2010 when SJK told the S.E.C. about the Montford payments. The gist of Montford's alleged infraction is not in receiving money to which he was not entitled – to the contrary, Montford earned the money – but was the fact that Montford did not disclose those payments to his clients. This fact pattern simply does not present a case for disgorgement. Disgorgement also may only be of the unfair windfall or profit portion of the ill-gotten gain. As the former Fifth Circuit held in *S.E.C. v. Blatt*, 583 F.2d 1325 (5th Cir. 1978): "Disgorgement is remedial and not punitive. The court's power to order disgorgement extends only to the amount with interest by which the defendant profited from his wrongdoing. Any further sum would constitute a penalty assessment."

Fourth, in considering the appropriate remedy, the Commission has emphasized whether the investment advisor has already "paid" for the alleged infractions. Here, Montford, as one of the fraud's main victims, has been punished enough. Montford not only stands to lose a portion of his retirement account, Montford's 22 year old business has been dealt a severe blow as a result of SJK's fraud, and Montford has incurred tens

of thousands of dollars in attorney's fees dealing with SJK's fraud and the resulting investigation. No further punishment is needed.

Finally, injunctive relief is unnecessary to ensure that Montford will comply with the law. *Slocum,* 334 F.Supp.2d 144 at 185 (injunctive relief under the Investment Advisors Act requires a showing of "some cognizable danger of recurrent violation, something more than the mere possibility which serves to keep the case alive" (citation omitted)). Montford has a spotless record of compliance in over two decades of business and has every incentive to comply with the law in the future. *See Monetta,* 390 F.3d at 958 (vacating Commission's order imposing sanctions because the Commission failed to consider, *inter alia,* the isolated nature of the violation).

This 27th day of October, 2011.

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